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What is Deflation and Why is it so Bad?
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For many years, the Federal Reserve's primary goal has been to maintain a sustainable rate of economic growth and keep inflation low and stable. At the Federal Reserve's Federal Open Market Committee (FOMC) meeting, held May 5-6, 2003, the inflation component of this goal was altered. Given the current very low level of inflation and the sluggish level of economic activity, the Federal Reserve is turning its focus away from keeping inflation low to keeping deflation from developing. This shift in the Federal Reserve's focus was evident in the FOMC's press release following its May meeting, which stated, "...the probability of an unwelcome substantial fall in inflation, though minor, exceeds that of a pickup in inflation from its already low level." This statement was essentially reissued following the FOMC's subsequent meeting on June 24-25, 2003. While the Federal Reserve did not specifically use the word "deflation", a "substantial fall in inflation" when inflation is already at a very low level, can only mean deflation.

What Is Deflation and Where Does It Come From?

Deflation is defined as a general ongoing decline in prices. Deflation is not present when prices fall only for a key commodity, such as oil, or in a particular sector, such as housing or motor vehicles. Deflation occurs only when the overall level of prices for goods and services is on a downward trend. Therefore, deflation is the opposite of inflation. Under inflation, prices in general are increasing and the Consumer Price Index (CPI) edges up. Under deflation, prices in general are declining and the CPI edges down.

Deflation has two main causes. First, deflation can be caused by weak economic activity. When demand for goods and services declines relative to the amount of goods and services being supplied, businesses react by reducing their prices in an attempt to increase their sales. Deflation occurs when such a price-cutting environment is widespread throughout the economy. Second, deflation can result from tight monetary policy. If the Federal Reserve allows the money supply to grow more slowly than the rate of growth in the demand for goods and services, then fewer dollars are available to spend on goods and services, and businesses lower their prices to help stimulate their sales. A short-run deflationary problem is typically caused by weak economic activity, whereas a more long-term deflationary problem tends to be due to monetary policy.

Deflation in the Past

As measured by the U.S. Consumer Price Index, which measures changes in retail prices of consumer goods and services, the U.S. economy has experienced an actual decline in the general level of prices from one year to the next only 12 times in the past 90 years. The nation's most serious bout with deflation occurred during the Great Depression, from 1930 to 1933, when overall consumer prices fell 24.0%. The last time prices fell on a annual basis was in 1955, when the U.S. CPI declined a modest 0.4%.

Why is Deflation Bad?

Deflation is undesirable because it tends to occur when economic activity is already weak and it will likely lead to even weaker economic times. Initially, some consumers may benefit from deflation because the goods and services they want and need become less expensive. However, this drop in prices can exacerbate economic conditions if the downward movement in prices persists. For example, if prices are falling, it means not only that goods are less expensive today compared with yesterday, but also that goods will cost even less tomorrow than they cost today. As a result, deflation produces the incentive for consumers and businesses to postpone purchases as long as possible. This postponement of purchases will cause economic activity to weaken even further.

Another negative offshoot of deflation is that debt burdens become more onerous. Under deflation, the decline in prices causes the purchasing power of a dollar to increase. As a result, debt incurred in the past is repaid with dollars that are worth more than when the debt was initially incurred, so debt holders will have to spend more in real terms to repay their debts. For example, if general prices decline by 5.0%, a homeowner's fixed monthly mortgage payment of $1,000, will increase $50 to $1,050 in real terms, or $600 for a full year. This increase in the real debt burden becomes even more troublesome if the homeowner's nominal income also declines due to a reduction in hours worked, a direct pay cut, or the loss of a job, all of which might be prevalent during the poor economic times that typically accompany a deflationary period. Business debt is affected in the same way. This increase in real debt levels is likely to cause increased personal and business bankruptcies, which will create problems for the nation's financial system and further undercut economic activity.

Actions To Prevent Deflation

To stop deflation from developing, the demand for goods and services must increase relative to the supply of goods and services. This can be accomplished using monetary and fiscal policy actions. The Federal Reserve can help stimulate demand for goods and services by reducing interest rates, which makes it less expensive for consumers and businesses to finance the purchase of consumer goods and business equipment. Given the Federal Reserve's cuts in interest rates during the past two years, including the reduction in the Federal Funds rate from 1.25% to 1.00% on June 25, 2003, the ability of the Federal Reserve to reduce interest rates much further is very limited because they are already at very low levels. However, the Federal Reserve still can help stimulate demand by buying government bonds. When the Federal Reserve buys Federal government bonds, it helps boost the money supply, which helps keep prices from declining. The Federal government also can help boost demand and keep prices from edging down by cutting taxes and/or increasing spending.

Is The U.S. Economy Headed Toward Deflation?

Due to the fact that the level of economic growth is fairly weak at the present time, combined with the fact that inflation is very low, deflation is a real possibility. However, the probability of deflation becoming a serious problem for the U.S. economy is very small for basically four reasons. First, the consensus economic forecast is that economic activity will start to show meaningful improvement by the end of 2003. If this forecast is correct, the demand for goods and services should increase, which will help bolster prices and head off any potential deflationary problem. Second, recent monetary and fiscal policy actions by the Federal government, which include the recent interest rate reduction, income tax reduction, and spending increases, also will help stimulate demand and therefore undercut deflation. Third, recent international monetary shifts should help relieve some of the downward pressure on U.S. prices. The value of the dollar has been edging down relative to the value of foreign currencies. As a result, the prices of goods being imported into the U.S. have been increasing and the prices of U.S. goods being exported to other counties have been decreasing. This shift in currency valuations will ease some of the downward price pressure on U.S. domestic businesses and help improve their profitability. This also should help stimulate economic activity and head off deflation. Fourth, the Federal Reserve is doing its job. Alan Greenspan, Chairman of the Federal Reserve, and the other members of the FOMC, have identified deflation as a potential problem and are poised to take the necessary actions to help keep deflation from even starting.